RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

SINCE 1958

PO Box 1759, La Jolla, California 92038

17 Letters Per Year - $250 Annually

LETTER 1346

December 24, 2002

Dec. 6, DJIA 8645.77; PTI 5252; A-D Ratio -3.95
Dec. 13, DJIA 8433.95; PTI 5250; A-D Ratio -4.30
Dec. 20, DJIA 8512.01; PTI 5250; A-D Ratio -4.09
S&P Yield: 1.78% S&P p/e: 29.52
Gold 50-Day MA: 322

JUST THE FACTS – You hear an awful lot of pure nonsense about the stock market. Personally, I prefer facts. One of the nonsense areas deals with "How many years in a row the market can go down."

The actual figures are as follows —

The Dow closed the year 1999 at 11497.12.

The Dow closed the year 2000 at 10786.85.

The Dow closed the year 2001 at 10021.50.

If the Dow closes **below 10021.50** on the last day of this year, the Dow will have been down three years in a row.

The last time this happened was in 1939 when the Dow ended the year at 150.24; in 1940 when the Dow ended at 131.3l; and in 1941 when the Dow ended at 110.96. What was happening during those years? Those were the years when Germany was winning the war, and it appeared that the Nazis had a good chance of taking over the world. Britain alone stood between the Nazis and their total conquering of Europe, while, in the meantime, Japan threatened all of Asia.

Next Mailing: January 14, 2003

There was only one time when the Dow declined for four consecutive years. That was in 1929 when the Dow ended the year at 248.48; in 1930 when the Dow ended at 150.24; in 1931 the Dow ended at 131.13; and in 1932 the Dow ended the year at 119.96. Those four years forecast the worst depression in US history. At the worst of the 1930's one-third of the nation was unemployed, and GDP had dropped in half.

So this has set me wondering. What could the current three consecutive years of Dow decline mean? Frankly, it's kind of scary to speculate on what these three down-years could be discounting.

I always start with "What's the worst that can happen?" Once you've dealt with the worst, everything else seems better. The worst that can happen, I believe, is that the US loses its position as the world's super-power and sinks into an extended, costly recession-depression. Who would be taking the US's place? It's got to be the world's fastest-growing major nation — China.

Now remember, the stock market looks ahead. In other words, the change in respective positions doesn't have to happen next year or the year after. The market could simply be issuing a warning, just as it did during those two other series of Dow declines.

The history of the world is a movement of power from one nation to the other — and a flow of funds from one nation to the next. Follow the flow of gold, follow the flow of real money, and it will tell you in which direction the power is flowing. Power, historically, has always gone to the gold accumulator and loss of gold has identified the nation that is losing power. On that basis again, the US fails the test, and China wins the contest or at least is in the process of winning the contest.

In these reports I don't "soften" my comments, and I don't allow hopes to obscure facts. The above is the way I see it. Three consecutive years down for the Dow is NOT a good sign. It's only happened twice before in history. True, the Dow is descending from a ridiculously over-valued area. But that could be part of the problem. The problem being that investors had bid up stocks to such ridiculous overvaluations in the first place.

The overvaluation was clearly part of the year 2000 perception that "America is the only world super-power," and that super-power status was worth the S&P at God-knows how many times phony earnings.

Was greed and pride the hallmark of the end of the greatest bull market in US history? It does seem so.

THE PICTURE – What's the difference between value and price? The "efficient market" theory claims that there is no difference. The market price of an item is what it's worth and what its value is.

In my opinion, the "efficient market" thesis is nonsense. For instance, I was around and studying the market in 1949. In June of 1949 the Dow stood at a low of 161. Is that what the Dow was worth in 1949? Of course not.

The sentiment in 1949 was very much a holdover of the recent past — from the 1930s and World War II. After the war times were tough, and by 1949 the nation was in recession. The talk was that "the War is over,

and the nation is now headed for another 'Great Depression.'"

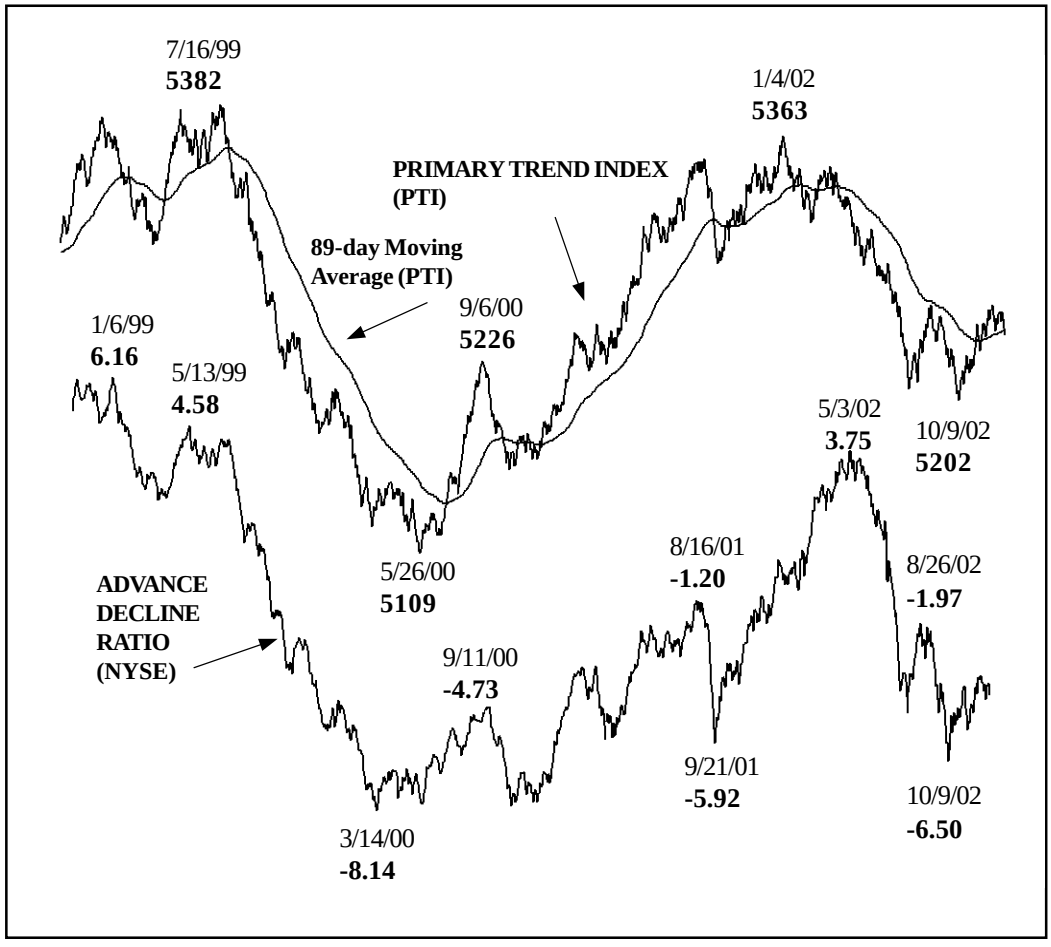
In 1949 there was very little interest in the stock market. Everybody was excited about advertising. Advertising, we were told, was the way of the future.

As a result, stocks were almost totally neglected, and in my high school class of 115 only one guy ended up on Wall Street, and he was there because his family was wealthy, and they wanted a "representative" on Wall Street.

I remember sitting in the Bache office on 42nd Street and Lexington Avenue with this guy (his name was Morris Gratz) and watching the tape stagger by to the tune of around 1.5 million shares a day. So the Dow in June of 1949 was selling at 161. Was that what those thirty Dow Industrial stocks were worth? Hardly. By 1955 the Dow had climbed to over 500. People in 1949 who thought that the Dow was worth exactly 161 were very wrong.

By the same token, the Dow in the year 2000 sold for 11,722. Was that what the Dow was worth, or was that just the price? Obviously, that was just the price, and that price was heavily influenced by years of hype, hope and hyperbole. Two years later the Dow sold in the 7000s.

The fact is that the stock market and stocks are always adjusting to a future reality. At times investors' perceptions of the future is far too pessimistic (as per 1949), and at other times investors become far too optimistic (as per the year 2000).



Where are we now? Are investors too optimistic or too pessimistic – or is the Dow right where is should be? Views vary, of course, but according to my Dow Theory studies the primary trend of the stock market is down.

I'm going on the thesis that once the best has been discounted by the stock market (i.e., a bull market top) the stock market will travel to the other extreme. The other extreme occurs when stocks have discounted the worst that can be seen ahead.

Ah, the question is asked, 'Why does the market have to go to extremes?" Why can't the market just fluctuate in the middle ground?" The answer is that the market goes to extremes because human nature evidently goes to extremes. This, to me, is one of the great mysteries of human psychology. And it's something that the mass of people never understands or never learns.

Behind this is the phenomenon that can best be expressed by "This time it's different," and "Things are never going to change." This mind-set is amazing because all history, in fact the whole history of mankind, demonstrates that the one certainty is that THINGS WILL CHANGE.

To take this to the present, an interesting example is gold. Following gold's surge to over 800 in early-1980, gold embarked on a long and discouraging (for gold bugs) bear market. The bear market lasted for 20 years, and during most of that time central bankers did their best to denigrate gold. Gold was called "a barbaric relic," it was called a metal only good for filling teeth. It was laughed at, scorned, even hated. This despite that gold had been accepted as money for six thousand years.

The twenty years of generally declining prices, reinforced by the various central banks' denigrating of gold, finally imprinted itself in the public's mind. "Gold is junk, gold is just a commodity, gold has gone nowhere, and gold never will go anywhere."

I had some money in the large Rowe Price family of funds, and I called this morning to switch my California muni money market fund to a gold fund. I was surprised when they told me that Price didn't even have a gold fund. They had a "natural resource fund" which may or may not hold gold stocks. I asked Price to close out my account and send me the money. I'll probably put the money in a no-load gold fund.

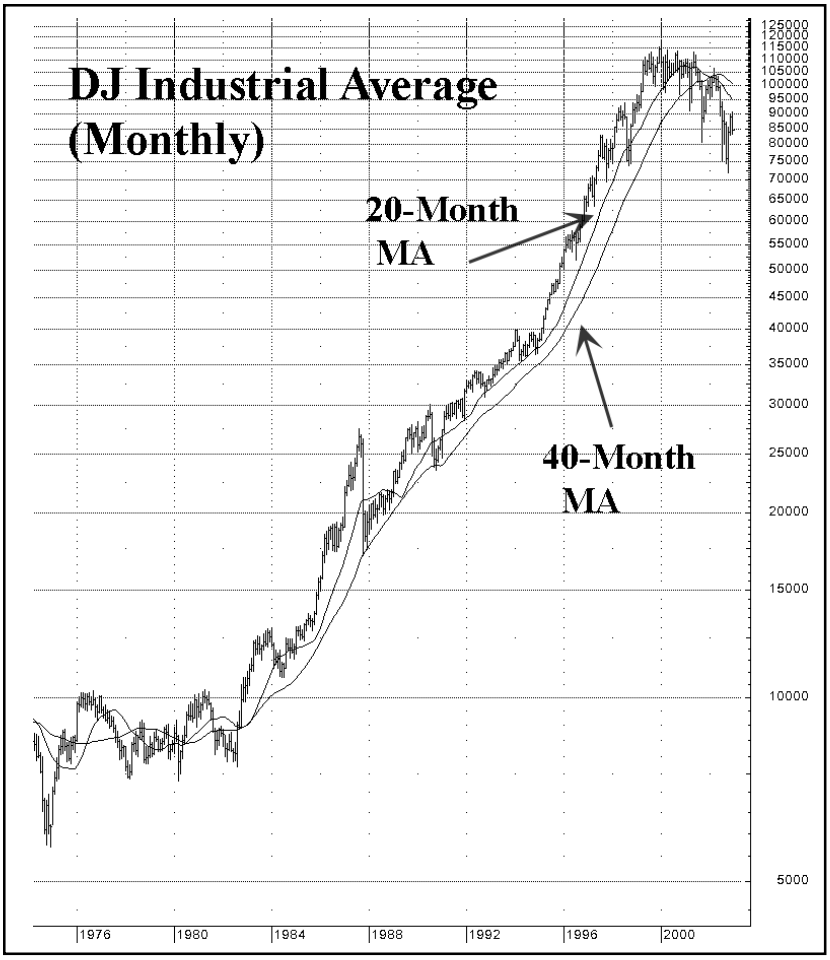
BIG, BIG PICTURE – I'm taking up a lot of room on page 5 to show you what I believe is the most important chart today. This is a monthly chart of the Dow going back to the 1970. What you see here is the Dow along with two long-term moving averages. I show the very long-term 40-month MA along with the faster-moving 20-month MA.

The last time the 20-month MA crossed below the 40-month MA was back in March of 1978. That was over 24 years ago. True, since 1978 the 20-month MA has come down to touch the 40-month MA twice since 1978 but the 20-month MA has never crossed and closed below the 40-month MA.

That is, until recently. In January 2002 the 20-month MA crossed decisively below the 40-month MA. Furthermore, both of these moving averages are now trending down. Thus, I believe that we are seeing the beginning of a great gathering primary bear market, a market that may be in force for many years.

How far will this bear market carry? There is obviously no way of telling. But just studying the chart you can see where the Dow could easily come down to 4000, 3000 or even lower.

After 24 years in which the 20-month MA never crossed below the 40-month MA, I have to think that the crossing in January 2002 has ominous implications. At any rate, that's the way Richard Russell sees the big picture here as we are about to move into the year 2003.



BEAR MARKET LOSSES – I hate to bring this up, but I've received so many e-mails telling me about tragic losses that I feel I should write something along these lines. I've written many times that in a primary bear market, everybody sustains losses. In fact I developed a thesis that runs like this – "In a bear market everyone loses – and the winner is the person who loses the least."

When I first wrote this seemingly nasty little sentence, people were incensed. They thought I was being too cynical. They thought this little sentence didn't apply to them. I believe after three years of this bear market the "unbelievers" have changed their minds. When I publish this sentence now, I don't receive any complaining e-mails or letters.

Look what's happened. Stocks have been hit hard. In their search for yield, many people moved into high-yield corporate bonds. They got hit hard by the declines in this area. Foreign stocks were supposed to be the place to be. But foreign shares have gone down along with US shares. Mutual funds were run by professionals and therefore supposed to be immune from decline. We know what happened in this area, with average funds down over 25% in 2002.

What's left? The dollar itself plus real estate and homes. My own guess is that both the dollar and real estate are living on borrowed time. Of course, so far, T-bills and cash have been two of the best places to be in this bear market. But it is interesting how one sector after the other has been hurt and in most cases hurt badly by the bear market. So if you've lost money so far in this, the greatest bear market since the 1930s, don't feel too badly. Everybody's lost money. And remember, the person who's lost the least is the winner.

Comments – The General Accounting Office is doing a study on why the public has ignored the latest effort to produce a coin dollar, the Sacagawea "dollar" coin. The Treasury has run a three-year $67 million dollar campaign to popularize this coin. The result. Nobody wants anything to do with the "new metal dollar."

Why is this? The Russell answer. The coin is ugly. It's too small, almost the size of a quarter. It's gold "covering" is phony and it tarnishes. If the Treasury really wants a gold coin that the public will use, it will have to bring out a larger, very attractive gold coin and a coin that actually has some intrinsic value. My suggestion is that the new coins should be either clad with real gold or contain around one-fortieth of an ounce of gold. In other words, it must have some intrinsic value.

The public isn't entirely stupid. It will take something different to make them want to hold and actually use

the coin. A coin with some intrinsic value would be a novelty for this generation of Americans. Of course, a coin with intrinsic value would scare hell out of the Fed and the Treasury. Start with intrinsic value in one place and the public might want intrinsic value behind all their currency. In that case, what would be the next step? God forbid, the public might demand gold instead of base metal and paper.

INVESTMENT POSTION — The bear, as you might have guessed, remains in the box. Yes, it's still a bear market, and it promises to be one for quite a while longer. The big question, and it's a very difficult question, is "What do we do with our money?"

I wish I had the perfect answer. I can tell you what you might do. First of all, you're probably going to need income. And income is damn hard to find today. I suggest discounted municipal bonds issued by entities in your own state. That could bring in 4.75% tax-free.

Of course, there's the problem that if the dollar tanks, rates will go up and your bonds will go down. In that case, you hold your bonds to maturity and you get back par (1000) for your bonds. One problem is that when your bonds mature, your 1000 may only be worth 800, but that's life in the US under a Federal Reserve that only knows how to do one thing – inflate.

OK, to offset the inflation danger you can buy gold coins and gold shares. If the dollar tanks, your gold and gold shares will almost surely be moving higher, as they have recently been doing. So I do recommend that everybody have some participation in gold, not so much to make a profit but really as insurance against an inflation-prone Fed.

How about stocks? They're the wrong things to own in a bear market. Sure one out of ten stocks might be a winner, but odds are that you'll buy a portfolio of the other nine. In a bear market, before it's all over, almost all stocks go down – the good stocks, the bad stocks, the ugly stocks. They all end up going down.

How about high-grade preferred stocks for income? They're OK if you pick the really high-grade ones like Virginia Electric or Detroit Electric preferred. Some knowledgeable bears advocate just holding cash. Cash is fine as long as you don't need income. But again, the question is how long will the dollar hold together.

In the final analysis, I think you need bonds for income, gold for insurance and safety, and preferreds again for income. This is a very difficult time for investors and for savers. These are difficult times because we're dealing with a nation that has lived beyond its means for many years.

ARCHIVE OF FORTY-FOUR YEARS OF DOW THEORY LETTERS – We've just received shipment of our new two-diskette CD, which contains all my Dow Theory Letters written since 1958. These two CDs track my comments on the stock market over the entire forty-four year span – all my struggles, all my successes, all my goofs, all that I learned in my battles in the toughest game in the world. It's a game where you play for keeps, and it's a game where the rules are forever changing.

Frankly, when I started in this business I wish I had had something like these two CDs. I don't think there is anything like these CDs on the market. Price $300, no refunds and we pay the postage.

Merry Xmas, Season's Greetings and for Seinfeld fans - Festivus for the rest of us.